APPENDIX II—Prior Art

(4 references)

THE HANDBOOK OF

EQUIPMENT LEASING

VOLUME TWO

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If there is a reduction in the amount of tax benefits received, the lessor needs to charge the lessee an additional amount to protect its yield. In essence, the lessor must charge the lessee for the negative tax consequences of the early termination.

Lost Rents

In an early termination, the lessee wants to cease using the equipment and stop paying rent. Even if the lessee is willing to pay a lump sum amount today, there is no guarantee the lump sum will compensate for the foregone income inherent in the remaining rents. For example, reinvestment opportunities may have changed dramatically.

Lessors also face the problem that debt is supporting the transaction, and the lender may not allow an acceleration of the debt payments. This mismatch between rent flow and debt flow can create significant interest spread problems going forward. Without the rents the lessor may not be able to pay the underlying lease debt, and the lender could call the loan and force a repossession of the equipment. Alternatively, costs could be associated with earlier repayment of the debt. These costs must be factored into the termination amount.

Lost Opportunity Cost

Even if the lessor receives termination cash from the lessee, there is no guarantee the lessor can reinvest the money at a yield commensurate with the yield on the original transaction. Therefore, the lessor can incur opportunity losses if market rates are significantly lower than the original yield.

In order to protect itself against lost opportunity cost, the lessor must charge the lessee the net present value of the rent, the residual and the lost tax benefits, discounted at the new or current market rate. This process makes the lessor indifferent between collecting cash today or collecting the lease payments over the original term. It is difficult to protect lessors against lost opportunity cost because most lessees cannot afford this option. Notwithstanding the foregoing, however, many lessors manage to include a premium in the termination value because the lessee is breaking the contract.

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TERMINATION OPTIONS

The last area for consideration in the equipment-related terms and conditions is the determination of what options, if any, will be granted to the lessee at lease expiration. These options include the purchase of the equipment, renewal of the lease or return of the equipment.

For some types of leases, the lease agreement may not contain any type of purchase option. This is especially true for those leases that are true rental contracts or in which the lessor specializes in a certain equipment type and does not wish to relinquish title to the equipment at lease expiration. Most leases, however, will contain some type of purchase option language.

Purchase Options

There are three common types of purchase options for those leases that include a right by the lessee to purchase the equipment at lease expiration.

Fair Market Value (FMV) Purchase Option

The FMV purchase option allows the lessee to purchase the equipment at lease expiration for whatever value the equipment holds at that time. Determination of this value is made either through a formal appraisal conducted by an independent third party or through an analysis of the secondary market by the lessor. (See the residual evaluation variables within the residual analysis section of this chapter for additional references.)

The most common definition of FMV states that fair market value is equal to the amount that would be obtained in an arms-length transaction between an informed and willing buyer and an informed and willing seller, with neither party under compulsion to buy or sell. This definition also assumes that the buyer is someone other than the current user of the equipment (lessee) and that no deductions are made for the cost of deinstallation and removal of the equipment from the current user's location.

The above definition of FMV, although common, is only one of many. Because of the wide variety of FMV definitions, disputes at lease expiration are quite common between lessees and lessors over this issue. The dispute usually centers around FMV options that do not clearly define the basis of value (the definition of FMV). Therefore, the utmost care needs to be taken in this area to make sure that a clear definition is used. For examples of various FMV definitions, interested parties may contact the American Society of Appraisers (ASA), the International Society of Appraisers (ISA) or the American Appraisal Association.

Put

A put is a fixed price residual payment due from the lessee upon lease ex- ration. The lessee in this situation has both the right and obligation to p the residual amount so the residual is considered and treated as a ballo payment on a conditional sales contract. The risk to the lessor for put resi uals is mainly a credit risk. The lessor should establish at lease inceptio that the put amount will not be greater than the equipment's expected resi ual value.

Call Option

A call option, also referred to as a fixed price purchase option, take on some of the characteristics of both the FMV and put purchas options. Under this option, the lessee is granted the right to purchas the equipment at lease expiration for a stated or estimated purchas price but it does not have the obligation to purchase the equipmen The most common language for this type of option falls into one o three formats:

1. The lessee has the right to buy the equipment for a fixed and stated purchase price at lease expiration
2. The lessee may purchase the equipment for its fair market value, with the fair market value amount not to exceed a stated purchase price
3. The lessee may purchase the equipment for fair market value or the stated purchase price, whichever is greater.

As the lessee is not obligated to purchase the equipment at lease expiration, the lessor carries almost the same level of residual risk as with an FMV purchase option, especially if the language shown in examples 1 or 2 above is used. Because of this risk, residual evaluation procedures at lease inception are critical.

Renewal Options

A renewal option grants the lessee the ability to extend the lease on a month-to-month basis or for a fixed term. The fixed term renewal period usually equals 12 to 36 months. For month-to-month renewals, the renewal rate (rental amount) usually is equal to the amount of the last rental within the original lease term. Fixed term renewal rates, however, generally are

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Return Options

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structured in one of two ways. The first is through a predetermined renewal rate. Under this method, the renewal rate quoted in the renewal option equals a fixed percentage of the last payment made within the original lease term or an amount equal to the last payment.

The second method is an FMV renewal rate in which the renewal rate is calculated in a manner similar to new lease pricing. The FMV of the equipment at lease expiration is used for calculation purposes instead of using original cost as the basis for pricing. The lessor may take a residual position, although the purchase option usually equals the equipment's FMV, similar to the structure of the original lease term.

Return Options

Return options were discussed previously in the section on return provisions in this chapter.

Options Affecting All or Portions of the Equipment

In some leases, the lessor states that any termination option chosen (purchase, renewal or return) must apply to all the equipment. This is the most common method used by lessors not specializing in a certain equipment type, as the lessor usually does not have the resources within the various in-house operations departments to accommodate nonstandard termination option choices. This is not to say the lessor would not consider such a choice at lease expiration, only that the lessor wants greater control. An unusual combination of termination options most likely will be offered only if it is financially attractive to the lessor.

It is quite common, however, for lessors that specialize in certain equipment types and that look at lease schedules on an asset level basis to allow the lessee to pick and choose the equipment it wants to purchase, renew or return. Specialized lessors generally have a more refined equipment remarketing capability and an asset-based lease accounting and management system that allows much greater flexibility in splitting schedules and tracking individual assets.

DISPOSITION OF EQUIPMENT

The disposition phase includes all the functions performed by the asset management group shortly before and after the lease term has expired. The functions in this phase include end-of-lease strategy development, end-of-